83-1618

No.

In the Supreme Court of the United States

OCTOBER TERM, 1983

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

TENNECO OIL COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REX E. LEE
Solicitor General

LOUIS F. CLAIBORNE
Deputy Solicitor General

ELLIOTT SCHULDER
Assistant to the Solicitor General

Department of Justice
Washington, D.C. 20530
(202) 633-2217

WILLIAM H. SATTERFIELD
General Counsel

JEROME M. FEIT
Solicitor

JOEL M. COCKRELL
Attorney

Federal Energy Regulatory Commission
Washington, D.C. 20426

QUESTION PRESENTED

Whether the sale by a natural gas producer to an interstate pipeline of a leasehold interest in proven gas reserves for use by the pipeline in supplying its interstate customers, which sale is in all significant respects the economic equivalent of a conventional wellhead sale, is a "sale in interstate commerce of natural gas for resale" within the jurisdiction of the Federal Energy Regulatory Commission under Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b).

PARTIES TO THE PROCEEDING

Public Agencies:

Federal

Federal Energy Regulatory Commission

State

People of the State of California
Public Utilities Commission of the State of California
Idaho Public Utilities Commission
Public Service Commission of Nevada
Public Utility Commissioner of Oregon
Washington Utilities & Transportation Commission
Public Service Commission of Wyoming

City

City of Ellensburg, Washington

Interstate Natural Gas Pipeline Companies:

El Paso Natural Gas Company
Northwest Pipeline Corporation

Distribution Companies:

Cascade Natural Gas Corporation
Colorado Interstate Gas Company
CP National Corp.
Intermountain Gas Company
Mountain Fuel Supply Company
Northwest Natural Gas Company
Pacific Gas and Electric Company
Rocky Mountain Natural Gas Company

San Diego Gas & Electric Company
Southern California Edison Company
Southern California Gas Company
Southern Union Company
Southwest Gas Corporation
Washington Natural Gas Company
Washington Water & Power Company

Producers:

El Paso's System	**Party**
GLA 47	Tenneco Oil Company Conoco, Inc.
GLA 51	Mapco, Inc. Hopi Oil Company
GLA 52	Tenneco Oil Company Conoco, Inc. Union Oil Company of California New York Life Insurance Company
GLA 60	Tenneco Oil Company Conoco, Inc. Charles Colwill Anne Home Emerson, Trustee Ina Belle Hightower Anna Lou Home Jean E. Keyser Cassandra Keyser Teresa Home Barron Kidd W. H. and Alberta A. Sloan Helen Ulmer van Atta
GLA 61	Sun Oil Company (Delaware)

El Paso's System	Party
GLA 62	FHN, Ltd.
GLA 63	Atlantic Richfield Company
GLA 66	W. Watson LaForce, Jr. Henry P. Isham, Jr. Estate Robert T. Isham Josephine C. Jacobson J. Roberts Jones Nancy LaForce Keyes Frederic P. G. Lattner, Trustee U/T Martha M. Lattner, Settlor Suzanne LaForce Baber James C. Bard Douglas N. Bard Ralph A. Bard, Jr. Roy E. Bard, Jr. G. R. Brainard, Jr. Trust Continental Illinois National Bank and Trust Company of Chicago, Trustee Trust #23935 Continental Illinois National Bank and Trust Company of Chicago, Trustee Trust #23949 Eleanor Isham Dunne Charles W. Farnham, Jr. Robert B. Farnham Walter B. Farnham Elizabeth B. Farrington Minnie A. Fitting R. U. Fitting, Jr. Estate Robert D. Fitting Nancy H. Gerson John R. Grimes Jay C. Halls and Ruth N. Halls, Trustees

El Paso's System	Party
	Ruth N. Halls
	Cortland T. Hill
	Elsie F. Hill
	Louis W. Hill, Jr.
	Albert L. Hopkins, Jr.
	George S. Isham
	R. S. MacDonald, A. MacDonald and Northern Trust Co., Trustees U/W of N. S. MacDonald, Deceased
	Mary F. Love
	William J. McDermott, Trustee
	Nora R. Ranney
	Catherine H. Ruml
	Edward L. Ryerson, Jr.
	Sabine Royalty Corporation
	Shaw, Isham & Company
	John I. Shaw, et al., Trustees
	Elizabeth B. Simpson Trust
	James Simpson, Jr. Trust
	William E. Simpson Trust
	Sydney Stein, Jr.
	Northern Trust Co., Trustee U/W of John Stuart
	Robert Douglas Stuart Estate
	William P. Sutter
	Michael Simpson Trust
	Patricia Simpson Trust
	Kay B. Towle
	Katharine I. White
	Kay B. Gundlach
	F. F. Webster Revocable Trust
	Frederick W. Webster
	Mary S. Zick

El Paso's System	Party
	David Waller Dangler
	Ralph U. Fitting, III, Executor of Estate of R. U. Fitting, Jr., Deceased
	J. Robert Jones, Executor of Estate of R. U. Fitting, Jr., Deceased
GLA 72, 86, 101, 127	Mapco, Inc.
	Hopi Oil Company
GLA 76	Union Oil Company of California
	First National Bank of Ft. Worth, Trustee for Eula May Johnston
	James J. Johnston
	Alvin C. Johnson, Trustee
	V. A. Johnson Family Trust
	Jones Company
	Wm. C. McMahan Estate
	Homer R. Stasney & Sons Company
	Rogers-Gibbard Trust
	Robert Beamon
	Thomas L. Hale
	Pattie Anne Beamon Lundell
	Orville Curtis Rogers, Trustee
	Veva Jane Gibbard, Trustee
GLA 77	Robert Beamon
	Robert Beamon, Trustee
	Pattie Ann Beamon Lundell
	Thomas L. Hale, Trustee
	First National Bank of Ft. Worth, Trustee for Eula May Johnston
	Rogers-Gibbard Trust
	James J. Johnston
	Alvin C. Johnson, Trustee

El Paso's System	Party
	V. A. Johnston A. V. Jones Company W. C. McMahan Homer R. Stasney
GLA 78	American Petrofina Company Tenneco Oil Company Conoco, Inc. Union Oil Company of California
GLA 106	Morris and Flora Mizel
GLA 122	Producing Royalties, Inc. Harold S. Long Dixie M. McLane Trust Mrs. Judy St. John Taylor John S. White
GLA 125	American Petrofina Company Anderson Construction Company, Inc. Benson-Montin-Greer Drilling Corp. Tom Bolack Oliver Benson Albert R. Greer Mary Eddy Jones Edna Fern Benson Walter Benson Charlene K. Greer Mary E. Jones and The First National Bank & Trust Company of Oklahoma City, Trustees U/W of F. Jones Late Oil Company A. C. Montin, Jr. William V. Montin Oklahoma and Northwestern Company

El Paso's System	Party
GLA 129	Delta Drilling Company Trustees of the DeGolyer Foundation Mrs. Nell V. Golyer 3-M Oil Company
GLA 139	Producing Royalties, Inc. James A. and Hazel H. Borland R. Lewis Chandler Trust Mary C. Fannin Charles E. Graham, Jr. Lewis Chandler Mrs. Carrie B. Graham Newell R. Hays Dixie M. McLane Grandchildren's Trust Critchell Parsons Judy St. John Taylor
GLA 152, 160, 231	J. Glenn Turner Sue Reeder Turner Trust William G. Webb
GLA 153	Gretchen A. Gartner Helen L. Harvey
GLA 157	Mapco, Inc. Barbara Ann Bruss O. J. Lilly Barbara Irene McConnell
GLA 172	Crown Central Petroleum Corporation
GLA 195	William G. Webb J. Glenn Turner
GLA 196	J. Glenn Turner Sue Reeder Turner Trust William G. Webb

El Paso's System	Party
	Benson-Montin-Greer Drilling Corp. Barbara Ann Bruss Charles Albert Greer La Plata Gathering System, Inc. O. J. Lilly Huerfanito Gas Co., et al. Barbara Irene McConnell Mary R. Boecking and H. E. Boecking, Jr., Trustees U/T of Mary M. Strachley Jacqulyn M. Williams
GLA 197	Huerfanito Drilling Company, Inc.
GLA 198, 248	J. Glenn Turner Sue Reeder Turner Trust William G. Webb Frank A. Schultz
GLA 249	Benson-Montin-Greer Drilling Corp. Barbara Ann Bruss Charles Albert Greer La Plata Gathering System, Inc. O. J. Lilly Barbara Irene McConnell Mary R. Boecking and H. E. Boecking, Jr., Trustees U/T of Mary M. Strachley J. Glenn Turner Sue Reeder Turner Trust Jacqulyn M. Williams
GLA 348	Union Oil Company of California Jones Company W. C. McMahan

El Paso's System	Party
	H. R. Stasney & Sons Company Alvin C. Johnson, Trustee
GLA 349	Union Oil Company of California A. V. Jones Co. W. C. McMahan Homer R. Stasney Robert Beamon and Robert Beamon, Trustee
GLA 350, 351	Robert Beamon Robert Beamon, Trustee Thomas L. Hale, Trustee Pattie Anne Beamon Lundell

Northwest's System	Party
PLA 2	Atlantic Richfield Company
PLA 3	Getty Oil Company
PLA 4	Grace M. Brown Catherine B. McElvain, Inc. and as Executrix of Estate of T. H. McElvain, Deceased T. H. McElvain Oil and Gas Properties James E. McElvain, Executor of Estate of Carl R. McElvain J. Wm. McElvain Estate of F. B. Miller Mabelle McElvain Miller Mrs. Ruth M. Vaughn
PLA 5	Phillips Petroleum Company
PLA 6	Amoco Production Company J. Ralph Ellis, Jr.

Northwest's System	Party
	Jones Felvey, II First National Bank in Dallas for the Acct. of J. Ralph Ellis, Jr. McCulloch Oil Corporation Mountain States Natural Gas Corp. John D. Mugg, Jr. Jack B. Ryan Texas Oil & Gas Corp. U.V. Industries
PLAs 7, 9, 10, 11	Amoco Production Company
PLA 8	J. Ralph Ellis, Jr. Jones Felvey, II First National Bank in Dallas for the Acct. of J. Ralph Ellis, Jr. H. M. Meredith, Trustee, and First National Bank in Dallas for the Acct. of J. Ralph Ellis, Jr. Mountain States Natural Gas Corp. John D. Mugg, Jr. Amoco Production Company Jack B. Ryan Texas Oil & Gas Corp.
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v.

TENNECO OIL COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Federal Energy Regulatory Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a)[1] is reported at 708 F.2d 1011. The orders of the Federal Energy Regulatory Commission (Pet. App. 21a-31a, 153a-154a) are reported at 12 F.E.R.C. ¶ 61,297 and 13 F.E.R.C. ¶ 61,239, respectively. The decision of the administrative law judge (Pet. App. 33a-120a) is reported at 6 F.E.R.C. ¶ 63,037. The

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[1] "Pet. App." refers to the appendix to the petition in No. 83-1321.

opinion of the district court (Pet. App. 121a-136a) is reported at 426 F. Supp. 963.

JURISDICTION

The judgment of the court of appeals (Pet. App. 145a-149a) was entered on July 5, 1983. Petitions for rehearing were denied on December 2, 1983 (Pet. App. 151a-152a). Justice White extended the time for filing a petition for a writ of certiorari to and including April 2, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and 15 U.S.C. 717r(b).

STATUTE INVOLVED

Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b), provides:

> The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

STATEMENT

A. Regulatory Background

This Court is familiar with the history of the Natural Gas Act, 15 U.S.C. 717 *et seq.* Prior to the enactment of that Act, the Court had held, in a series

of cases, that the Commerce Clause barred the states from regulating sales of natural gas for resale in interstate commerce. As a result of these rulings, wholesale gas transactions in interstate commerce were left entirely unregulated. The overriding purpose of Congress in the Natural Gas Act was to close this regulatory gap. In Section 1(b) of the Act, 15 U.S.C. 717(b), the Commission[2] is given jurisdiction over natural gas companies engaged in the transportation or sale of natural gas for resale in interstate commerce, but not over the "production or gathering" of natural gas. Natural gas companies subject to Commission jurisdiction under the Act are required to obtain from the Commission certificates of public convenience and necessity before they may engage in such sales (15 U.S.C. 717f(c)) and the rates they charge for such sales must be just and reasonable (15 U.S.C. 717c).

In *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954), this Court held that conventional wellhead sales of natural gas by an independent producer to an interstate pipeline for resale in interstate commerce did not fall within the "production or gathering" exemption but were subject to Commission jurisdiction under the Natural Gas Act. Thereafter, in *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392 (1965) (commonly referred to as the "*Rayne Field*" case), the Court held that sales of gas leases from a "proven and substantially developed" field, which accomplish the transfer of large volumes of natural gas to an interstate pipeline com-

[2] Both the Federal Energy Regulatory Commission and its predecessor agency, the Federal Power Commission, are referred to herein as the "Commission".

pany for resale in the interstate market, are likewise within the Commission's jurisdiction under the Act.[3]

B. Factual Background

1. In 1948, six years before *Phillips* and 17 years prior to *Rayne Field*, El Paso Natural Gas Company (El Paso), an interstate pipeline, entered into a contract with Delhi Oil Corporation (Delhi) to purchase gas produced by Delhi at Barker Dome in northwestern New Mexico, near the San Juan Basin. The history of the Barker Dome transaction is detailed in the decision of the administrative law judge (Pet. App. 44a-51a). For present purposes, it is sufficient to note that, before the contract became effective, Delhi became concerned that a conventional wellhead sale, such as that proposed in its contract with El Paso, might be subject to regulation by the Commission. Accordingly, Delhi, acting upon advice of counsel, insisted that the transaction be recast in lease-sale form (Pet. App. 49a-50a).[4] This new arrangement placed Delhi and El Paso in about the same economic position each would have enjoyed under a conventional wellhead sales contract.

Thereafter, Delhi and other producers acquired control over vast amounts of proven gas reserves in

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[3] These cases and others are discussed in greater detail at pages 11-19, *infra*.

[4] The lease-sale agreement in *Rayne Field*, like that at Barker Dome, was adopted as a substitute for a conventional wellhead sales contract. See page 12, *infra*. In his initial decision, the administrative law judge observed that "[t]he Barker Dome dealings * * * probably represented a more blatant attempt to evade Federal regulation than the scheme which occurred in the *Rayne Field* case" (Pet. App. 105a).

the San Juan Basin (Pet. App. 56a-57a).[5] Again, following advice of counsel, Delhi insisted on selling its reserves to El Paso under a lease-sale agreement (*id.* at 60a). In an agreement designated GLA-47,[6] Delhi transferred in place to El Paso an estimated 1.063 trillion cubic feet of gas (R. 9692).[7] The parties anticipated that 179 billion cubic feet would be extracted from the properties during the first four years (*ibid.*). Shortly after the closing of GLA-47 in March of 1952, El Paso began taking into its interstate system large volumes of natural gas from the San Juan field (Pet. App. 60a; R. 5241-5246).

Subsequently, other San Juan Basin producers transferred their reserves to El Paso under similar lease-sale agreements. In all, El Paso entered into some 36 lease-sale agreements in the San Juan Basin (35 of which are in issue here), acquiring gas underlying more than a quarter of a million acres (Pet. App. 61a).

2. In 1952, Pacific Northwest Pipeline Corporation (PNW), the predecessor of respondent Northwest Pipeline, sought Commission authorization to

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[5] By 1950, the San Juan Basin was already known as one of the major fields of gas in place in North America (R. 9936; Pet. App. 52a-55a). ("R." refers to the record in the court of appeals.)

[6] "GLA" refers to the producer lease-sale agreements with El Paso. "PLA" refers to the producer lease-sale agreements with the predecessor of Northwest Pipeline Corporation (Northwest).

[7] The Commission relied on these reserves in authorizing El Paso to expand its pipeline facilities at an estimated capital cost of about $46 million. *El Paso Natural Gas Co.*, 11 F.P.C. 1071, 1074 (1952).

construct an interstate pipeline system from the San Juan Basin to the Pacific Northwest. In attempting to secure reserve dedications to support its application before the Commission, PNW offered the various Basin producers the option of either a conventional wellhead sale of natural gas or a sale of reserves in place (Pet. App. 74a-75a).

In 1953, PNW and Phillips Petroleum Company (Phillips) executed a conditional lease-sale agreement for the transfer of gas in place (PLA-5), covering about 200,000 acres in the Basin and an estimated three trillion cubic feet of gas (Pet. App. 75a). The Phillips-PNW contract was contingent on PNW's receipt of a Commission certificate to construct its proposed pipeline and on PNW's obtaining satisfactory financing commitments from a reputable financial institution (*id.* at 77a).

Thereafter, other San Juan Basin producers entered into similar conditional agreements with PNW (Pet. App. 77a-82a). In 1954, the Commission granted PNW a certificate authorizing it to construct its pipeline system into the Pacific Northwest.[8] The Commission subsequently approved PNW's financing plan, thereby permitting PNW to close its conditional gas agreements. On September 1, 1956, construction of the PNW pipeline was completed and natural gas began to flow from the San Juan Basin to consumers in the Pacific Northwest (*id.* at 82a).

3. In most respects, the terms of the above described lease-sale agreements were similar. The agreements called for the pipelines to compensate the interest owner of the acreage by paying a special

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[8] *Northwest Natural Gas Co.*, 13 F.P.C. 221 (1954).

"overriding royalty."[9] The royalty was to be calculated as a specified sum per Mcf of gas produced from the acreage and was subject to periodic escalation. At the end of a fixed term, the royalty was subject to redetermination (either by agreement of the parties or through arbitration) based upon the market value of the gas. The lease agreements conveyed rights only to gas, not oil, and imposed strict drilling obligations upon the pipelines designed to ensure that the leases would be fully and promptly developed. In addition, many of the agreements included conventional favored nations clauses[10] and take-or-pay clauses.[11]

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[9] An ordinary royalty, commonly referred to as a base royalty, is the landowner's share of the profits of production, free of the expenses of production. This royalty is frequently set at one-eighth of production profits. An overriding royalty is an interest in oil and gas produced at the surface and is assessed above and beyond the base royalty. In general, overriding royalties do not exceed one-eighth of production, and smaller fractions are common. See H. Williams & C. Meyers, *Manual of Oil and Gas Terms* § 418, at 340 (1981). In the instant case, by contrast, the pipelines were required to pay a special overriding royalty on the entire net interest assigned to them by the producers (*i.e.*, the interest remaining after deduction of the base and conventional overriding royalties). The net interest assigned in GLA-47 was approximately 70%; in PLA-5 the net interest assigned was about 80%.

[10] The typical favored nations clause provided that the interest owner would receive the highest overriding royalty rate paid by the pipeline producer for gas production under any lease-sale agreement covering acreage located within 200 miles of the interest owner's acreage (Pet. App. 73a).

[11] Under a take-or-pay clause, the lessee is obligated to pay for a specified minimum volume of gas production from the acreage, regardless whether that volume is actually produced and taken into the pipeline (Pet. App. 51a n.40).

4. The instant controversy arose in 1973, when El Paso and Sun Oil Company (Sun) were unable to agree on a mutually acceptable royalty rate for one of the lease contracts. In the absence of agreement, the contract provided for determination of the royalty rate by a board of arbitrators, which was to base its decision on the current value of the gas at the wellhead (Pet. App. 40a).

At Sun's request, the dispute was submitted to the board, which agreed with Sun that the royalty should be based on the going wellhead price for natural gas in the higher priced intrastate market rather than the lower regulated rate for interstate sales of gas of the same vintage (Pet. App. 40a). Soon thereafter, other San Juan Basin producers demanded redetermination of the rates applicable to their overriding royalties, under either rate redetermination or favored nations clauses in their lease-sale agreements (*id.* at 40a-41a).

C. The Rulings of the District Court and the Commission

El Paso subsequently brought suit in the United States District Court for the Western District of Texas, arguing that the lease sales were subject to Commission jurisdiction under the Natural Gas Act and, therefore, that the arbitration award could not exceed the applicable Commission price ceiling. El Paso also filed a complaint with the Commission, seeking a determination that the lease-sale agreements were subject to the Commission's jurisdiction. Northwest intervened in both the district court and Commission proceedings and sought a declaration of jurisdiction with respect to its lease sales.

The district court and the Commission reached conflicting conclusions. The court held that the lease sales were not subject to Commission jurisdiction

(Pet. App. 121a-136a). The Commission, on the other hand, held that it had jurisdiction over the transactions under this Court's decision in *Rayne Field* (Pet. App. 21a-31a, adopting the decision of the administrative law judge, Pet. App. 33a-120a). The Commission based its ruling on what it perceived to be the economic and commercial realities of the lease-sale transactions, finding that here, as in *Rayne Field*, the lease sales were the economic equivalent of conventional wellhead sales because they accomplished the transfer of large volumes of proven natural gas reserves from producers to pipelines for resale in interstate commerce. In the Commission's view, these economic and commercial realities compelled the conclusion that the transactions were subject to regulation under the Natural Gas Act.

D. The Opinion of the Court of Appeals

The court of appeals reversed the Commission and affirmed the district court (Pet. App. 1a-19a). The court noted that, although the issue was "of substantial significance," it was "difficult to decide" because "[n]either the statute nor the cases give definitive direction" (*id.* at 11a). The court concluded, however, that the Commission had misconstrued *Rayne Field* by elevating "economic equivalency * * * from a component in the *Rayne Field* test to the determinative factor on the issue" (*id.* at 12a-13a). In the court's view, the Commission erred in not focusing sufficiently on the requirement that the reserves be "substantially developed" at the time of the lease sales to assure " 'imminent ability to produce in commercial quantities' " (*id.* at 15a, quoting *Continental Oil Co.* v. *FPC*, 370 F.2d 57, 64 (5th Cir. 1966), cert. denied, 388 U.S. 910 (1967)). The court explained (Pet. App. 15a):

> While the Commission's down-playing of the development issue may well foreshadow the next stage in the evolution of the law, for the time being our precedents demand full application of all components of the *Rayne Field* test, including the proven and substantial development factor * * *. We perceive the *Rayne Field* test to reflect the Supreme Court's concern with the apparent congressional intent not to regulate production. A purely economic test would seem to encroach on that concern.

The court of appeals acknowledged that "the reserves in the Basin may well have been 'proven' at least within reasonable estimates" (Pet. App. 15a). It concluded, however, that, "because the acreage was not substantially developed, the agreements in issue were not sales of gas under the Natural Gas Act" (Pet. App. 17a). The court acknowledged that an important factor on which it relied in reaching its decision was "the limited extent to which the Basin had been drilled at the time the [lease agreements] were executed" (*id.* at 15a).

REASONS FOR GRANTING THE PETITION

This case presents an important question concerning the scope of the Commission's jurisdiction under the Natural Gas Act. Although the court of appeals purported to apply settled precedent in deciding this jurisdictional issue, the effect of the court's ruling is to broaden the scope of the "production or gathering" exemption of Section 1(b) of the Act, 15 U.S.C. 717(b), beyond the intent of Congress as construed in the decisions of this Court. The decision below is at odds with the teachings of this Court in *Phillips* and *Rayne Field,* and is inconsistent with a number of other court of appeals decisions. If allowed to

stand, the decision below would preclude the Commission from effectively regulating the rates charged for gas produced from fields that are major sources of gas supply for the two major interstate pipelines that serve the western United States.[12] It would also have a significant financial impact on the pipelines and their customers. In these circumstances, review by this Court is warranted.

1. Prior to *Phillips*, the governing rule was that lease transfers were not subject to the Commission's jurisdiction under Section 1(b) of the Natural Gas Act. See *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949). Expressing the view that "leases are an essential part of production" (*id.* at 505), the Court in *Panhandle* concluded that "the transfer of undeveloped gas leases is an activity related to the production and gathering of natural gas and beyond the coverage of the Act" (*id.* at 515).

In *Phillips*, however, the Court rejected such a formalistic reading of the "production or gathering" exemption. The Court stated that " '[e]xemptions to the primary grant of jurisdiction in the section [1(b)] are to be strictly construed' " (347 U.S. at 679 (footnote omitted), quoting *Interstate Natural Gas Co.* v. *FPC*, 331 U.S. 682, 690-691 (1947)).[13] As the Court viewed the legislative history of the Natural Gas Act, Congress intended "to give the

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[12] El Paso serves markets in Texas, New Mexico, Arizona, Nevada and California. Northwest serves markets in Colorado, Wyoming, Idaho, Oregon, Washington and Nevada.

[13] The Court noted, in this regard, that the relevant committee reports "reveal that a construction of the 'production or gathering' exemption which would substantially limit the affirmative grant of jurisdiction to the Commission was not contemplated" (347 U.S. at 679 n.7).

Commission jurisdiction over the rates of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not and whether occurring before, during, or after transmission by an interstate pipeline company" (347 U.S. at 682 (footnote omitted)). The Court noted that, because the rates charged by independent producers for these sales "may have a direct and substantial effect on the price paid by the ultimate consumers," its decision was consistent with the primary purpose of the Natural Gas Act, which was to protect consumers "against exploitation at the hands of natural-gas companies" (*id.* at 685).

The Court's reading of the congressional purpose in *Phillips* led it to change its analytical approach in determining the question of Commission jurisdiction over lease-sale agreements. This new approach was enunciated in *Rayne Field.* There, the parties had initially structured the transaction as a conventional wellhead sale, which clearly would have been considered jurisdictional under *Phillips.* However, after a decision in another case [14] indicated that the proposed rates would not be approved by the Commission, the parties recast the transaction in lease-sale form in the expectation that the transaction would be considered outside the Commission's jurisdiction under *Panhandle.* The Commission rejected this effort to escape its jurisdiction. In its view, to make the result turn on whether the transaction "was cast as a sale of leases instead of a sale of natural gas 'would exalt form over substance, would give greater weight to the technicalities of contract draftsmanship than to

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[14] *Public Service Commission* v. *FPC,* 257 F.2d 717 (3d Cir. 1958), aff'd *sub nom. Atlantic Refining Co.* v. *Public Service Commission,* 360 U.S. 378 (1959) (the "*Catco*" case).

the achievement of the purposes of the Natural Gas Act, and would impair [its] ability to control the price received for gas sold to the pipelines in interstate commerce to the detriment of the ultimate consumer'" (*Rayne Field*, 381 U.S. at 398, quoting *Texas Eastern Transmission Corp.*, 29 F.P.C. 249, 256 (1963)). The Fifth Circuit, however, relying on *Panhandle*, concluded that the leases "relate to the production or gathering of natural gas and are thus outside Commission jurisdiction" (*Marr* v. *FPC*, 336 F.2d 320, 325 (1964)).

This Court reversed, concluding that the lease sales could be considered "sales" of natural gas in interstate commerce for purposes of the Natural Gas Act. The Court explained (381 U.S. at 401 (citation omitted)):

> The sales of leases here involved were, in most respects, equivalent to conventional sales of natural gas which unquestionably would be subject to Commission jurisdiction under *Phillips* * * *. Indeed, the context of this case shows that when the first plan was aborted by the *Catco* case, the parties did not alter their objectives, but merely the method of attaining them. * * * There are differences, to be sure, between the original sale agreements and the lease-sale plan. * * * But it is perfectly clear that the sales of these leases in Rayne Field, a proven and substantially developed field, accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States. That is the significant and determinative economic fact. To ignore it would substantially undercut *Phillips*, and because of it the Commission * * * acted properly in treating these sales of leasehold in-

terests as sales of natural gas within the meaning of the Natural Gas Act.

The Court emphatically rejected the contention that the lease sales were outside Commission jurisdiction because of the "production or gathering" exemption. Instead, it concluded that "even though a sale of natural gas in interstate commerce occurs before production or gathering is ended, it is nonetheless subject to regulation" (381 U.S. at 402). The Court noted that if the "production or gathering" exemption were construed as turning "purely on a matter of the timing of the title transfer," that would mean that any sale of gas in place would fall within the exemption (*ibid.*). In the Court's view, "[a]cceptance of any such narrow interpretation would make *Phillips* a shadow" (*ibid.*).

The decision below erroneously limits *Rayne Field* to its specific facts while disregarding the central teaching of that case and *Phillips*—that all wholesales of gas in interstate commerce, whether cast in the form of conventional sales contracts or lease transactions, are jurisdictional. Thus, contrary to the view of the court of appeals (Pet. App. 14a-15a), in determining whether a transaction is subject to regulation under the Natural Gas Act, the controlling factor is not the form, but the economic and commercial substance of the transaction. To be sure, as this Court pointed out in *Rayne Field*, "substantiality of development is a relevant consideration, for the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce" (381 U.S. at 403). However, it is one thing to say, as this Court did in *Rayne Field*, that substantiality of development is *a*

relevant consideration; it is quite another to conclude, as did the court of appeals in this case, that substantiality of development is the sine qua non of Commission jurisdiction over lease-sale agreements. Indeed, if substantiality of development were an essential predicate to jurisdiction, it would have been wholly unnecessary for the Court in *Rayne Field* to have stressed that "even though a sale of natural gas in interstate commerce occurs before production or gathering is ended, it is nonetheless subject to regulation" (381 U.S. at 402), and that "the 'production or gathering' exemption relates to the physical activities, processes and facilities of production or gathering, but not to sales of the kind affirmatively subjected to Commission jurisdiction" (*ibid.*).

To the extent that the court of appeals may have relied on this Court's decision in *Panhandle* to support the result below (see Pet. App. 15a), that reliance is completely misplaced. The Court in *Rayne Field* distinguished *Panhandle* on the ground that it "did not involve a sale of natural gas for resale in interstate commerce, but a transfer * * * for sale of the gas in *intra*state commerce" (381 U.S. at 403-404 (emphasis in original)). Although the Court noted that *Panhandle* was also distinguishable because it involved the transfer of undeveloped leaseholds (381 U.S. at 403), the Court expressly disapproved certain broad language in *Panhandle*, including the statement that " 'leases are an essential part of production' " (381 U.S. at 404 (quoting *Panhandle*, 337 U.S. at 505)). The Court emphasized that such flat statements "should not be taken to cover more than the particular kind of leases that were before the Court; it should not be considered as embracing each and every transfer that can be put in lease form" (381 U.S. at 404).

The court below also erroneously relied (Pet. App. 15a) on *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), cert. denied, 406 U.S. 976 (1972), which held that the typical lease agreement, granting the right to explore for gas on the lessor's property, is not subject to Commission jurisdiction. The court in *Mobil*, unlike the court of appeals in this case, recognized that *Phillips* and *Rayne Field* "were written with full awareness of the significance, in commercial and regulatory terms, of the sales of gas by independent producers to interstate pipeline companies" (463 F.2d at 261-262). Indeed, the court in *Mobil* pointed out that *Rayne Field* was grounded on the realization that "these lease transfers were the equivalent 'in economic effect to the concept of conventional sales' and such conclusion was required so as not to open gaps in Federal regulation" (463 F.2d at 262). The court emphasized that the jurisdictional foundation under the Natural Gas Act—"sales in interstate commerce"—was admitted in *Phillips* and "exist[ed] through economic equivalent in *Rayne Field*" (463 F.2d at 262). In contrast, "an ordinary lease by a landowner to a producer * * * is neither a 'customary' sale in interstate commerce nor its equivalent in economic effect" (*ibid.*). Unlike a lease-sale agreement involving proven reserves, as in this case and *Rayne Field*, a typical gas lease transfers "only the right to explore, develop, and market if exploration is successful; no royalty is paid if no gas is discovered" (463 F.2d at 262). Moreover, the landowner's royalty is generally payable on 12½% of production, not, as here (and in *Rayne Field*), on the entire net interest assigned, which amounts to between 70% and 80% of production. Thus, far from supporting the decision below, the *Mobil* case merely

serves to underscore the error of the court of appeals in rejecting the Commission's focus on commercial realities.[18]

2. The decision of the court of appeals cannot be reconciled with its own decision in *Continental Oil Co.* v. *FPC*, 370 F.2d 57 (5th Cir. 1966), cert. denied, 388 U.S. 910 (1967) (*Ship Shoal*), and is at odds with the decision of the Tenth Circuit in *Cities Service Gas Co.* v. *FPC*, 424 F.2d 411 (1969).

In *Ship Shoal*, the court (per Judge Wisdom) acknowledged that the leaseholds were "a 'long way' from being fully developed" (370 F.2d at 66). In fact, at the time of the lease-sale agreement, there was only one gas well, which was shut-in and had no production history, and it was calculated that at least 34 to 40 additional completions would be necessary

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[18] Furthermore, the court of appeals' holding that properties must be substantially developed at the time the lease agreements are signed overlooks the undisputed economic fact that producers generally will not commit capital to develop their properties until a market for the gas has been found and a long term gas purchase contract has been executed (see Pet. App. 110a). Thus, the court below plainly erred in examining the substantiality of development at the time the contracts were executed rather than at the time the gas properties were transferred. Since the jurisdictional inquiry under *Rayne Field* focuses on what was sold or transferred to the pipeline (*i.e.*, gas or something other than gas), and because Commission jurisdiction under the Natural Gas Act attaches only at the time of gas delivery and not at the time of execution of the sales contract (see, *e.g.*, *Tenneco Exploration, Ltd.* v. *FERC*, 649 F.2d 376, 379-380 (5th Cir. 1981)), the relevant date is clearly the transfer date. In this regard, the finding of the court below (Pet. App. 16a) that no wells had been drilled on the PLA-5 acreage at the time of the agreements is misleading; at the time of transfer, there were 75 wells on the acreage.

(*ibid.*). The court nevertheless held the lease sale to be jurisdictional, concluding that the gas field had "reached the stage of proof and development necessary to satisfy the *Rayne* criteria" (370 F.2d at 64). In reaching this result, the court pointed to (1) the pipeline's willingness to invest more than $97 million to connect its facilities with the underlying reserves; (2) the pipeline's reliance on those reserves to support its application to the Commission for authorization to construct the necessary facilities; (3) the Commission's approval of the pipeline's application; and (4) the pipeline's estimate that once production began it could extract a substantial percentage of the reserves during the first four years (370 F.2d at 65-66).

It is clear that the decision in *Ship Shoal* did not turn on the sort of mechanical well-counting approach engaged in by the court of appeals in this case. Rather, the court concluded (370 F.2d at 67):

> The crucial fact here, as in *Rayne*, is that the assignment of the leases accomplished the transfer of large amounts of substantially proven offshore natural gas reserves to an interstate pipeline company for eventual resale in interstate commerce. The transaction was a sale of a definable volume of gas, the price of which was geared to the actual volume found, and payment for which was directly related to its production —even if there has also been a transfer of an interest in real property. If such sales were not subject to Commission regulation, an "attractive gap" in the regulatory system would be created, and the producing states would be unable to close it.

Similarly, in *Cities Service*, the Tenth Circuit observed that the continuing validity of *Panhandle* was

"clouded" by *Rayne Field*, which the court construed as holding that the Commission "ha[s] jurisdiction over the sale of proven reserves to a pipeline" (424 F.2d at 416). See also *Louisiana Land & Exploration Co.* v. *FERC*, 574 F.2d 204, 207 (5th Cir. 1978), cert. denied, 439 U.S. 1127 (1979) ("economic realities * * * determine whether a jurisdictional sale has occurred").

3. Under the approach mandated by this Court in *Rayne Field*, the dispositive question is whether what was sold was gas or merely the right to explore for gas. In our view, the lease-sale agreements in this case clearly involved sales of natural gas in interstate commerce subject to the Commission's jurisdiction under the Natural Gas Act.

Here, as in *Ship Shoal*, the San Juan Basin reserves were relied on by El Paso to support a major expansion of its interstate pipeline facilities and by PNW to construct its entire interstate pipeline system. The Commission similarly relied on the reserves in certificating both construction requests. In its order granting El Paso's application for a certificate authorizing the expansion of its facilities shortly after the closing on GLA-47, the Commission removed a 34 Bcf annual ceiling on San Juan Basin volumes transported through the pipeline's system. *El Paso Natural Gas Co.*, 11 F.P.C. 1071, 1074 (1952). The Commission's action was wholly in accord with Delhi's own estimate that El Paso could produce 179 Bcf of gas, or 16.8% of the estimated recoverable reserves from GLA-47, in the first four years of production (R. 9692). By contrast, only 10% of the reserves involved in the transaction held jurisdictional in *Ship Shoal* were estimated as recoverable in the first four years (370 F.2d at 66). Fi-

nally, as soon as the pipelines' facilities were connected, substantial volumes of natural gas began to flow from these reserves into interestate commerce.

By rejecting the Commission's economic equivalency test in favor of its own mechanical well-counting approach, the court below has effectively rejected the teachings of *Phillips* and *Rayne Field* and has returned to the discredited approach of *Panhandle*. As a consequence of its erroneous approach, the court has reopened the regulatory gap that existed prior to enactment of the Natural Gas Act.

4. Unless overturned, the decision below would have a substantial adverse impact—both immediate and prospective—on the pipelines and on gas consumers in the western states, particularly California.

In 1974, following the Sun arbitration award (see page 8, *supra*), El Paso and Northwest entered into settlements with the producers in which the pipelines (while expressly reserving the right to litigate the jurisdictional issue) agreed to pay an overriding royalty based on the Commission's "new" gas ceiling rate even though most of the lease-sale gas was "old", lower-priced gas. As of June 1, 1983, for example, the ceiling rate for "new" gas under Section 102 of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3312, was $3.421 per MMBtu, whereas the maximum lawful price for "old" gas under Section 104 of the NGPA, 15 U.S.C. 3314, ranged from 46.7 cents to 83.6 cents per MMBtu. See 48 Fed. Reg. 18795 (1983) (to be codified at 18 C.F.R. 271.101). Between 1974 and 1983, the overriding royalties paid by El Paso and Northwest to the producers were passed through by the pipelines to their customers and to the ultimate consumers under the cost-of-service approach. If the decision below is overturned and the Commission is held to have juris-

diction, the customers would be entitled to substantial refunds. Although refund estimates vary, the general consensus among the pipelines, their customers, interested state commissioners and the Commission staff is that such refunds would exceed $1 billion.

The future impact of the decision below is even more substantial. In *Public Service Commission* v. *Mid-Louisiana Gas Co.*, No. 81-1889 (June 28, 1983), this Court held that "first sales" of pipeline produced gas are subject to the price ceilings established in Title I of the NGPA. If the lease transactions are deemed to be nonjurisdictional, then under *Mid-Louisiana* the pipelines' sales of their production would be considered first sales within the meaning of the NGPA and the pipelines could charge their customers only the applicable NGPA rate rather than the cost-of-service rate (which takes into account the overriding royalty). The pipelines would still be required, however, to continue their royalty payments to the producers based on the NGPA's "new" gas ceiling rate, which is substantially higher than the applicable NGPA rate (see page 20, *supra*). As a result, the pipelines would suffer a loss of more than $2.00 per MMBtu for much of the gas they produce.[16] Of course, the pipelines could seek special rate relief from the Commission pursuant to Section 104(b)(2) of the NGPA, 15 U.S.C. 3314(b)(2), but that would simply shift liability back to the consumers. In this regard, the future financial impact of the decision below would likely outweigh the past impact, because

[16] Following the court of appeals' decision, El Paso determined that the GLA wells are unprofitable and attempted to reassign the wells to the producers under a provision in the GLA agreements. On February 15, 1984, a Texas court ruled that El Paso had no right to reassign the leases.

the lease-sale acreage remains a major source of supply for the two pipelines, containing estimated reserves of three trillion cubic feet of gas. If, on the other hand, the lease-sale transactions are held to be jurisdictional, then the pipelines would pay the producers an overriding royalty equal to the lower NGPA rate less the cost of production; the pipelines' customers, in turn, would pay the applicable NGPA price for the gas. In short, review by this Court is essential to ensure the effective protection of consumers from excessive charges.[17]

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[17] It should be noted that the financial impact of this case far exceeds that in *Ashland Oil Co.* v. *Good*, No. 83-1234, *Mobil Oil Corp.* v. *Batchelder*, No. 83-1248 and *Cities Service Oil Co.* v. *Matzen*, No. 83-1278, which are pending before this Court on petitions for certiorari. In those cases, several natural gas producers entered into leases with landowners permitting them to explore for and produce natural gas on the leasehold acreage in return for royalty payments based on one-eighth of the "market value" of the gas. The gas produced from these fields was ultimately sold in interstate commerce and the producers paid royalties based upon applicable federal ceilings for "old" or "flowing" gas. The Supreme Court of Kansas held, however, that under the market value clause in the leases, the royalties should have been based on the higher price ceilings applicable to "new" gas. According to the producers in *Ashland*, the Kansas Supreme Court's decision would increase the royalties owed to the landowners to approximately 60% of the revenues received by the producers for sales of the gas. In contrast, the decision below would require the pipelines to pay royalties that are more than 400% greater than the price the pipelines could collect under the NGPA.

The Commission has filed an amicus brief in *Ashland* contending that the Kansas court's decision interferes with the Commission's implementation of the just and reasonable ratemaking scheme of the Natural Gas Act and thus is preempted by that Act. Here, as in *Ashland*, the impact of the lower court's decision collides with the primary purpose of the Nat-

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

REX E. LEE
Solicitor General

LOUIS F. CLAIBORNE
Deputy Solicitor General

ELLIOTT SCHULDER
Assistant to the Solicitor General

WILLIAM H. SATTERFIELD
General Counsel

JEROME M. FEIT
Solicitor

JOEL M. COCKRELL
Attorney

Federal Energy Regulatory Commission

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ural Gas Act, *i.e.*, "[p]rotection of consumers against exploitation at the hands of natural-gas companies" (*Phillips*, 347 U.S. at 685). Unlike *Ashland*, however, this case involves activity that is directly subject to the Commission's regulatory authority.

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